APPENDIX A

THE STATE OF SOUTH CAROLINA
IN THE SUPREME COURT

GEOFFREY, INC.,
Appellant,

v.

SOUTH CAROLINA TAX COMMISSION,
Respondent.

Appeal from Greenville County
Larry R. Patterson, Judge

Opinion No. 23886
Heard April 7, 1993—Filed July 6, 1993

AFFIRMED

Cary H. Hall, Jr., of Wyche, Burgess, Freeman & Parham, P.A., of Greenville, for Appellant.

Chief Deputy Attorney General Ray N. Stevens and Deputy Attorney General Ronald W. Urban, both of Columbia, for Respondent.

HARWELL, C.J.: Geoffrey, Inc. (Geoffrey), a foreign corporation, appeals from a ruling that requires it to pay South Carolina income tax and business license fees. We affirm.

I. FACTS

Geoffrey is a wholly-owned, second-tier subsidiary of Toys R Us, Inc. (Toys R Us) incorporated in Delaware with its principal offices in that state. It has no employees or offices in South Carolina and owns no tangible property here.

In 1984, Geoffrey became the owner of several valuable trademarks and trade names, including "Toys R Us." Later that year, Geoffrey executed a License Agreement (Agreement) that allows Toys R Us to use the "Toys R Us" trade name, as well as other trademarks and trade names, in all states except New York, Texas, Pennsylvania, Massachusetts, and New Jersey. The Agreement further grants Toys R Us a right to use Geoffrey's merchandising skills, techniques, and "know-how" in connection with marketing, promotion, advertising, and sale of products covered by the Agreement.

As consideration for the licenses granted by the Agreement, Geoffrey receives a royalty of one percent "of the net sales by [Toys R Us], or any of its affiliated, associated, or subsidiary companies, of the Licensed Products sold or the Licensed Services rendered under the Licensed Mark." Toys R Us reports the aggregate sales of all stores to Geoffrey in a single figure on a monthly basis. The royalty payment is made annually via wire transfer from a Toys R Us account in Pennsylvania to a Geoffrey account in New York.[1]

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[1] The net effect of this corporate structure has been the production of "nowhere" income that escapes all state income taxation. *See* Rosen, *Use of a Delaware Holding Company to Save State Income Taxes*, 20 Tax Adviser 180 (1989). One commentator has recognized such income as the "product of a divide and conquer strategy that some members of the corporate world have exercised effectively for decades." Corrigan, *Interstate Corporate Income Taxation—Recent Revolutions and a Modern Response*, 29 Vand. L. Rev. 623, 629 (1976). The strategy's effectiveness is unquestionable. In 1990, Geoffrey, without any full-time employees, had an

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Toys R Us began doing business in South Carolina in 1985 and has since then made royalty payments to Geoffrey based on South Carolina sales. In 1986 and 1987, Toys R Us deducted the royalty payments made to Geoffrey from its South Carolina taxable income. The South Carolina Tax Commission (Commission) initially disallowed the deduction, but later took the position that Toys R Us was entitled to the deduction and that Geoffrey was required to pay South Carolina income tax on the royalty income. The Commission also held that Geoffrey was required to pay the South Carolina corporate license fee.

Geoffrey paid the taxes under protest and filed this action for a refund, claiming, among other things, that it did not do business in South Carolina and that it did not have a sufficient nexus with South Carolina for its royalty income to be taxable here. The trial judge upheld the Commission's assessment of taxes against Geoffrey. Geoffrey appealed.

II. DISCUSSION

S.C. Code Ann. § 12-7-230 (Supp. 1992), pursuant to which both foreign and domestic corporations are taxed, provides:

> [E]xcept as otherwise provided, every foreign corporation transacting, conducting, doing business, or having an income within the jurisdiction of this State, whether or not the corporation is engaged in or the income derived from intrastate, interstate, or foreign commerce, shall make a return and shall pay annually an income tax equivalent to five percent of a proportion of its entire net income, to be determined as provided in this chapter. The term "transacting", "conducting", or "doing business", as used in this section, includes the engaging in or the transacting

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income of approximately $55 million and paid no income taxes to any state.

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of any activity in this State for the purpose of financial profit or gain.

Section 12-3-270 levies a tax on the income of foreign corporations "transacting, conducting, doing business, or having an income *within the jurisdiction of this State,*" which "includes," but is not limited to, "the engaging in or the transacting of any activity in this State for the purpose of financial profit or gain." We construe this language as extending to the limits of the constitution South Carolina's authority to tax foreign corporations. Here, Geoffrey contends that the Due Process Clause, U.S. Const. amend. XIV, § 1, and the Commerce Clause, U.S. Const. art. I, § 8, cl. 3, prohibit the taxation of its royalty income by South Carolina. We disagree.

A. *Due Process*

The Due Process Clause requires "some definite link, some minimum connection, between a state and the person, property or transaction it seeks to tax," and that the "income attributed to the state for tax purposes must be rationally related to values connected with the taxing State." *Quill Corp. v. North Dakota,* —— U.S. ——, ——, 112 S.Ct. 1904, 1909-10, 119 L.Ed.2d 91, 102 (1992). Geoffrey argues that the Commission has failed to satisfy both of these requirements. We disagree.

The nexus requirement of the Due Process Clause can be satisfied even where the corporation has no physical presence in the taxing state if the corporation has purposefully directed its activity at the state's economic forum. *Quill,* —— U.S. at ——, 112 S.Ct. at 1909-10. 119 L.Ed.2d at 104. Geoffrey asserts that it has not purposefully directed its activities toward South Carolina. To support its position, Geoffrey points out that Toys R Us had no South Carolina stores when it entered into the Agreement and urges, therefore, that Toys R Us's subsequent expansion into South Carolina was unilateral activity that cannot create the minimum connection be-

tween Geoffrey and South Carolina required by due process.

In our view, Geoffrey has not been unwillingly brought into contact with South Carolina through the unilateral activity of an independent party. Geoffrey's business is the ownership, licensing, and management of trademarks, trade names, and franchises. By electing to license its trademarks and trade names for use by Toys R Us in many states, Geoffrey contemplated and purposefully sought the benefit of economic contact with those states. Geoffrey has been aware of, consented to, and benefitted from Toys R Us's use of Geoffrey's intangibles in South Carolina. Moreover, Geoffrey had the ability to control its contact with South Carolina by prohibiting the use of its intangibles here as it did with other states. We reject Geoffrey's claim that it has not purposefully directed its activities toward South Carolina's economic forum and hold that by licensing intangibles for use in South Carolina and receiving income in exchange for their use, Geoffrey has the "minimum connection" with this State that is required by due process. *See American Dairy Queen Corp. v. Taxation and Revenue Dep't*, 93 N.M. 743, 605 P.2d 251 (1979); *Aamco Transmissions, Inc. v. Taxation and Revenue Dep't*, 93 N.M. 389, 600 P.2d 841, *cert. denied*, 93 N.M. 205, 598 P.2d 1165 (1979).

In addition to our finding that Geoffrey purposefully directed its activities toward South Carolina, we find that the "minimum connection" required by due process also is satisfied by the presence of Geoffrey's intangible property in this State. Geoffrey's Secretary, a certified public accountant, agreed during cross examination that sales by Toys R Us in South Carolina create an account receivable for Geoffrey. In addition, the trial judge found that Geoffrey had a franchise in South Carolina.[2] That the

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[2] "In its simplest terms, a franchise is a license from the owner of a trademark or trade name permitting another to sell a product or service under that name or mark. More broadly stated, a 'fran-

presence of these intangibles is sufficient to sustain a tax is settled law. In *Virginia v. Imperial Coal Sales Co., Inc.*, 293 U.S. 15, 20, 55 S.Ct. 12, 14, 79 L.Ed. 171, 175 (1934), the United States Supreme Court stated:

> It is not the character of the property that makes it subject to such a tax, but the fact that the property has a situs within the state and that the owner should give appropriate support to the government that protects it. That duty is not less when the property is intangible than when it is tangible. Nor are we able to perceive any sound reason for holding that the owner must have real estate or tangible property within the state in order to subject its intangible property within the state to taxation.[3]

Geoffrey asserts that under the doctrine of *mobilia sequuntur personam*, the situs of its intangibles is its corporate headquarters in Delaware, not South Carolina. However, in *Mobil Oil Corp. v. Comm'r of Taxes of Vermont*, 445 U.S. 425, 100 S.Ct. 1223, 63 L.Ed.2d 510 (1980), the United States Supreme Court rejected the view that the constitution requires taxation of intangibles by allocation to a *single* situs, finding no adequate justi-

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chise' has evolved into an elaborate agreement under which the franchisee undertakes to conduct a business or sell a product or service in accordance with methods and procedures prescribed by the franchisor, and the franchisor undertakes to assist the franchisee through advertising, promotion, and other advisory services." *Black's Law Dictionary* 592 (5th ed. 1979). Geoffrey has not challenged the trial judge's finding that the Agreement created a franchise.

[3] Although the tax at issue in *Imperial Coal* was an *ad valorem* property tax imposed upon the accounts receivable of a Virginia corporation, we do not find that fact distinguishing. Authority to tax the property extends to income produced by the property. "That [a state] may tax the land but not the crop, the tree but not the fruit, the mine or well but not the product, the business but not the profit derived from it is wholly inadmissible." *Sheffer v. Carter*, 252 U.S. 37, 49-50, 40 S.Ct. 221, 225, 64 L.Ed. 445 (1920).

fication for preferring that rule over taxation by apportionment. The High Court concluded that:

> [a]lthough a fictionalized situs of intangible property sometimes has been invoked to avoid multiple taxation of ownership, there is nothing talismanic about the concepts of "business situs" or "commercial domicile" that automatically renders those concepts applicable when taxation of income from intangibles is at issue. The Court has observed that the maxim *mobilia sequuntur personam*, upon which these fictions of situs are based, "states a rule without disclosing the reasons for it.". . . The Court has also recognized that "the reason for a single place of taxation no longer obtains" when the taxpayer's activities with respect to the intangible property involve relations with more than one jurisdiction. . . . Even for property or franchise taxes, apportionment of intangible values is not unknown. . . . Moreover, cases upholding allocation to a single situs for property tax purposes have distinguished income tax situations where the apportionment principle prevails. (Citations omitted).

Id. at 445, 100 S.Ct. at 1235, 63 L.Ed.2d at 525-26. *See also Wheeling Steel Corp. v. Fox*, 298 U.S. 193, 56 S.Ct. 773, 80 L.Ed. 1143 (1936) (intangibles may acquire a situs for taxation other than at the domicile of the owner if they have become integral parts of some local business); *Southern Express Co. v. Spigener*, 118 S.C. 413, 110 S.E. 403 (1920) (the situs of intangible property is within this State if the right afforded by it is exercised here); Dexter, *Taxation of Income from Intangibles of Multistate-Multinational Corporations*, 29 Vand. L. Rev. 401 (1976); J. Hellerstein & W. Hellerstein, *State Taxation*, Para. 9.08-.09 (2d ed. 1992). We reject Geoffrey's claim that its intangible assets are located exclusively in Delaware. Accordingly, we find that Geoffrey's purposeful direction of activity toward South Carolina as well as its possessing intangible property here pro-

vide a definite link between South Carolina and the income by Geoffrey from the use of its trademarks and trade names in this State.

We also find that the second prong of *Quill* test has been met. Contrary to Geoffrey's assertion, South Carolina has conferred benefits upon Geoffrey to which the challenged tax is rationally related. As the United States Supreme Court recognized in *Curry v. McCanless*, 307 U.S. 357, 365-66, 59 S.Ct. 900, 905, 83 L.Ed. 1339, 1347 (1939):

> Very different considerations, both theoretical and practical, apply to the taxation of intangibles, that is, rights which are not related to physical things. Such rights are but relationships between persons, natural or corporate, which the law recognizes by attaching to them certain sanctions enforceable in courts. The power of government over them and the protection which it gives them cannot be exerted through control of a physical thing. *They can be made effective only through control over and protection afforded to those persons whose relationships are the origin of the rights* . . . . Obviously, as sources of actual or potential wealth—which is an appropriate measure of any tax imposed on ownership or its exercise—*they cannot be dissociated from the persons from whose relationships they are derived.* (Citations omitted). (Emphasis added).

The real source of Geoffrey's income is not a paper agreement, but South Carolina's Toys R Us customers. Cf. *Avco Financial Services Consumer Discount Co. v. Director, Division of Taxation*, 100 N.J. 27, 494 A.2d 788 (1985). By providing an orderly society in which Toys R Us conducts business, South Carolina has made it possible for Geoffrey to earn income pursuant to the royalty agreement. *See, e.g., Allied Signal v. Comm'r of Finance*, 79 N.Y.2d, 588 N.E.2d 731, 580 N.Y.S.2d 696 (1991) (benefits afforded to an in-state corporation inure

to non-resident shareholders). That Geoffrey has received protection, benefits, and opportunities from South Carolina is manifested by the fact that it earns income in this state. *Accord Aamco*, 93 N.M. at 393, 600 P.2d at 845 (quoting *Besser Co. v. Bureau of Revenue*, 74 N.M. 377, 394 P.2d 141 (1964)). That the tax is rationally related to these protections, benefits, and opportunities is evidenced by the fact that the State seeks to tax only that portion of Geoffrey's income generated within its borders. Based on the foregoing reasons, we hold that the Due Process Clause does not prohibit South Carolina's taxation of Geoffrey's royalty income.

B. *Commerce Clause*

A tax will survive challenge under the Commerce Clause so long as it 1) is applied to an activity with a substantial nexus with the taxing state, 2) is fairly apportioned, 3) does not discriminate against interstate commerce, and 4) is fairly related to the services provided by the State. *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274, 279, 97 S.Ct. 1076, 1079, 51 L.Ed.2d 326, 331 (1977). Relying on *Nat'l Bellas Hess, Inc. v. Dep't of Revenue of Ill.*, 386 U.S. 753, 87 S.Ct. 1389, 18 L.Ed.2d 505 (1967), Geoffrey contends that it does not have a substantial nexus with South Carolina because it is not physically present in this state. In our view, Geoffrey's reliance on the physical presence requirement of *Bellas Hess* is misplaced.[4]

It is well settled that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there. The presence of intangible property alone is sufficient to establish nexus. *American Dairy Queen*,

[4] The U.S. Supreme Court recently revisited the physical presence requirement of *Bellas Hess* and, while reaffirming its vitality as to *sales and use taxes*, noted that the physical presence requirement had not been extended to other types of taxes. *Quill*, —— U.S. at ——, 112 S.Ct. at 1914, 119 L.Ed.2d at 108.

93 N.M. at 747, 605 P.2d at 255. *See also Int'l Harvester Co. v. Wisconsin Dep't of Taxation*, 322 U.S. 435, 441-442, 64 S.Ct. 1060, 1063-64, 88 L.Ed. 1373, 1379 (1944) (a state may tax such part of the income of a non-resident as is fairly attributable either to property located in the state or to events or transactions which, occurring there, are within the protection of the state and entitled to the numerous other benefits which its [sic] confers); J. Hellerstein & W. Hellerstein, *supra*, at 6.08 (any corporation that regularly exploits the markets of a state should be subject to its jurisdiction to impose an income tax even though not physically present). A taxpayer who is domiciled in one state but carries on business in another is subject to taxation measured by the value of the intangibles used in his business. *Curry*, 307 U.S. at 368, 59 S.Ct. at 906, 83 L.Ed. at 1348. We hold that by licensing intangibles for use in this State and deriving income from their use here, Geoffrey has a "substantial nexus" with South Carolina.[5]

Geoffrey finally contends that even if it is subject to South Carolina income tax, all of its royalty income would be allocated or apportioned to Delaware pursuant to S.C. Code Ann. §§ 12-7-1120(5) or 12-7-1140 (1977 and Supp. 1992). These statutes are inapplicable to the income received by Geoffrey. Section 12-7-1120(5) allocates gains or losses from the sale of intangible personal property not connected with the business of the taxpayer, other than any intangible personal property held for sale to customers in the regular course of business. Section 12-7-1140 apportions the income of taxpayers whose principal business in this State is (a) manufacturing or any form of collecting, buying, assembling or

[5] Further discussion of the remaining requirements of the Commerce Clause is unnecessary. Our Due Process analysis of the benefits conferred upon Geoffrey applies with equal force here and need not be repeated. Moreover, Geoffrey raised no constitutional claim that the challenged tax is not fairly apportioned or discriminates against interstate commerce.

processing goods and materials within this State, or (b) selling, distributing or dealing in tangible personal property within this State.

In conclusion, we hold that the taxation of Geoffrey's royalty income pursuant to section 12-7-230 is not prohibited by the Due Process Clause or the Commerce Clause of the United States Constitution. Our finding that Geoffrey may be taxed pursuant to section 12-7-230 settles the question whether Geoffrey must pay the corporate license fee. All corporations subject to section 12-7-230 are required to do so. *See* S.C. Code Ann. §§ 12-19-20, 12-19-70 (1977 & Supp. 1992). The order of the trial judge is

AFFIRMED.

CHANDLER, FINNEY, TOAL and MOORE, JJ., concur.

APPENDIX B

STATE OF SOUTH CAROLINA)
)
COUNTY OF GREENVILLE)

IN THE COURT OF COMMON PLEAS

Case No. 90-CP-23-3939

GEOFFREY, INC.,
Plaintiff,

vs.

SOUTH CAROLINA TAX COMMISSION,
Defendant.

FINAL ORDER

The dispute in this matter has given rise to several issues. After a review of the prior Summary Judgment Motion, which was postponed by Judge McGowan, Jr., the issues raised in this action will be discussed along with the relevant facts surrounding each issue.

A. Previous Partial Summary Judgment Motion.

The Partial Summary Judgment Motion was heard by Judge Frank McGowan, Jr. and resulted in the following order dated December 21, 1990:

> Defendant South Carolina Tax Commission's Motion For Partial Summary Judgment is denied at this time. Further inquiry must be had for legal and/or factual issues.

The basis for the Tax Commission's Partial Summary Judgment Motion was that the Complaint set forth five

issues in five causes of action, but in the Tax Commission's view, three of the issues were not raised in the administrative hearing held by the South Carolina Tax Commission. Thus, the argument to this court was that these alleged new issues are improper since the taxpayer failed to exhaust its administrative remedies. At the hearing before this court the parties argued this matter.

1. Issues Asserted As Not Raised Below.

There are three issues which the Tax Commission asserts the taxpayer did not raise at the administrative level. The asserted first new issue is that taxing the taxpayer violates Due Process because the taxpayer has insufficient connections to South Carolina. The asserted second new issue is that taxing the taxpayer's income violates Interstate Commerce since the imposition of tax against Geoffrey is unreasonable and impermissible. The asserted third new issue which the Tax Commission says is not raised at the administrative level is the taxpayer alleges that even if the taxpayer were properly taxed by the South Carolina Tax Commission, the income is allocated away from South Carolina to Delaware under S.C. Code Ann. §§ 12-7-1120 and 12-7-1130 (1976).

2. Conclusions As to Issues Raised Below.

After a review of the arguments before this court, it is the court's finding that there has not been a failure to exhaust administrative remedies. The three issues in dispute are properly before this court and all issues are addressed on their merits.

B. Issues Raised By The Pleadings.

Five issues are raised. First, the taxpayer alleges that its income is not subject to tax under § 12-7-230. Second, the Complaint asserts the imposition of the tax by § 12-7-230 violates Due Process. The basis for this assertion is that the taxpayer has insufficient connections to South

Carolina, and further, the income South Carolina seeks to tax has insufficient connections to South Carolina. The third issue raised is whether the imposition of tax violates Interstate Commerce since imposing the tax in the words of the Complaint is "unreasonable" and "impermissible." The fourth issue is that if the taxpayer's income is taxable, is the income taxable in South Carolina, or rather, is such allocated to Delaware by § 12-7-1120 or § 12-7-1130. The final issue is that the taxpayer alleges the license fee imposed on the taxpayer is improper for the same four reasons identified above. In other words, if the income tax is proper, then the parties agree that the license fee is proper. Each of these issues is addressed below.

1. Tax Under § 12-7-230.

a. The Statutory Language.

The relevant language of § 12-7-230, the statute that imposes the income tax on foreign corporations, is as follows:

> . . . every foreign corporation transacting, conducting, doing business or having an income within the jurisdiction of this State, whether or not such corporation be engaged in or the income derived from intrastate, interstate, or foreign commerce, shall make a return and shall pay annually an income tax equivalent to six percent of a proportion of its entire net income, to be determined as provided in this chapter. The term "transacting," "conducting," or "doing business," as used in this section shall include the engaging in or the transacting of any activity in this State for the purpose of financial profit or gain.

Satisfying two elements will bring a taxpayer within this statute and it is the finding of this court that each of those elements is met here. First, the taxpayer must

be a foreign corporation. There is no dispute over this element since the taxpayer is a corporation chartered in Delaware in 1984.

The second element, and the one which is in dispute, is that the corporation must fall within one of four broad categories. It must be transacting, conducting, doing business, or having an income within South Carolina.

The language used by the General Assembly and the legislative history make it clear that this statute is to have a wide scope. The literal language of the statute supports the view that this statute is intended to be all encompassing. First, the statute does not exempt a taxpayer just because the taxpayer has income or activities taking place in more than one state. The statute taxes income "whether or not the corporation is engaged in or the income is derived from intrastate, interstate, or foreign commerce." Second, the General Assembly further emphasized the breadth of this statute by explaining that the four broad categories identified above "include[] the engaging in or the transacting of any activity in this State for the purpose of financial profit or gain." Third, when the statute sets out a meaning for the four broad categories it uses the word "includes." Thus, the meaning given by the General Assembly was not limited to the definition alone, but rather, such categories should cover other activities of a taxpayer not mentioned specifically in the statute. Additionally, the definition used by the statute says that a taxpayer is within the imposition statute if there is "any activity in this state." In other words, the degree or extensiveness of the activity is not a factor, but rather, the mere presence alone in the state of the activity is enough to bring the taxpayer within the imposition.

Not only is the language of the statute broad but the legislative history of the statute shows an increasingly broad approach to taxing parties who have the benefit of South Carolina's resources and protection. The 1927

Acts and Joint Resolutions, Act 1, p. 1, set the original tax on corporations and the only language used was that of "doing business" in South Carolina, and thus, established the first category of activities subject to tax. That statute was expanded in the 1930 Acts and Joint Resolutions, Act 803, p. 1339, by adding to the original "doing business", the second category of activities by using the phrase ". . . or having an income within . . ." South Carolina. This language was again expanded a third time by the 1958 Acts and Joint Resolutions, Act 693, p. 1666. There the third and fourth categories of activities were introduced as being "transacting" or "conducting" business in South Carolina. Further, to make its point clear, the General Assembly in Act 693 explained that the terms "transacting, conducting or doing business" include "any activity in this state for the purpose of financial gain."

b. Transacting, Conducting, Doing Business, Or Having An Income Within South Carolina.

The statutory language in question has not been construed by any decision of our Appellate Courts, and thus, there is no judicial authority on how the language is to be applied. However, essentially, the inquiry becomes one of deciding if the taxpayer's activity seeks a profit or financial gain and does that activity take place in South Carolina. This court concludes the facts, the longstanding administrative practice of the Tax Commission, and the case law all demonstrate that under this inquiry, the taxpayer here is within the imposition statute of § 12-7-230.

The facts show that the taxpayer's activities were for the purpose of seeking a profit and a financial gain. The taxpayer's License Agreement demonstrates how the taxpayer's total activity in South Carolina is aimed at "the purpose of financial profit or gain." At Article III, the agreement grants to the taxpayer a royalty of 1% on

the net sales of Toys "R" Us. Clearly, there is no royalty unless there is a sales activity in South Carolina. The taxpayer's trademark is displayed on all six of the Toys "R" Us retail stores in the state as well as on the merchandise and in the advertisements that enable it to produce the royalties. To ensure that the trademark remains profitable in South Carolina, the taxpayer is contractually allowed to defend the trademark against infringements. Thus, the evidence establishes that the activity of Geoffrey is to derive a profit or financial gain.

It is also established that the profit seeking activity takes place in South Carolina. The profitable activity can take place nowhere else other than where the trademark is displayed. It is at that location that the trademark generates sales and those sales generate royalties for the taxpayer. In short, since the sales that produce the royalty are in South Carolina, the profit making activity is in South Carolina. This view is supported both by the longstanding administrative practice of the Tax Commission as well as by the case law of South Carolina.

The Tax Commission's longstanding administrative practice is evidenced by numerous taxpayers whose sole activities in South Carolina are limited to the single activity that earns the income. For example, finance companies are taxed in South Carolina based on whether the borrower resides in this state. Engineers and architects are taxed here if they perform any services in the state. Law firms and accounting firms are subject to tax based on where they perform the services for which they are paid. Restaurant franchise companies that have no activity in this state except the presence of their franchise name from which they derive their income are subject to tax in South Carolina. The longstanding administrative practice of an agency charged with enforcement of specialized statutes are [sic] not to be overturned in the absence of compelling reasons. *Multi-Cinema Ltd. v. South*

Carolina Tax Com'n., 292 S.C. 411, 357 S.E.2d 6 (1987). Here there are no such compelling reasons.

Case law supports the administrative practice. In *Lockwood Greene Eng. v. South Carolina Tax Com'n.*, 293 S.C. 447, 361 S.E.2d 346 (1987), the activity that earned the income was the engineering activity. The court found that since the engineer rendered his services where he physically worked, then the income derived from those services was part of the receipts of the state in which the engineer was located. Thus, work performed in South Carolina was held to be South Carolina receipts.

Here, just as in *Lockwood Greene,* the facts show that the activity that produces the income is activity which takes place in South Carolina. Accordingly, the facts show the taxpayer's activities are for the purpose of financial profit or gain. Additionally, the facts, longstanding administrative practice and case law also show the profit activity occurs in South Carolina. Thus, the taxpayer is subject to tax under § 12-7-250.

2. Due Process And Interstate Commerce.

The broad general principles governing Due Process have been well-established.

> . . . the Due Process Clause of the Fourteenth Amendment imposes two requirements: a "minimal connection" between the interstate activities and the taxing State, and a rational relationship between the income attributed to the State and the intrastate values of the enterprise. [cites omitted]. The requisite "nexus" is supplied if the corporation avails itself of the "substantial privilege of carrying on business" within the State; and "[t]he fact that a tax is contingent upon events brought to pass without a state does not destroy the nexus between such a tax and transactions within a state for which the tax is an exaction. [cites omitted]

Mobil Oil Corp. v. Com'r. of Taxes of Vermont, 100 S. Ct. 1223, 1231 (1980).

Thus one issue under Due Process is whether the facts show that the appropriate level of activity exists in South Carolina so that there is "nexus" between the royalty activities and South Carolina. A second issue under Due Process is whether a rational relationship exists between the amount of income attributed to South Carolina and the activities in South Carolina. The "nexus" question is determined on the facts based on the extent of activity in South Carolina. The "rational relationship" question is determined based on how South Carolina determines the tax liability of the taxpayer. In other words, the method for determining the tax liability must be based on some rational method connected with the taxpayer's activity in South Carolina.

a. Nexus For Due Process And Interstate Commerce.

The United States Supreme Court has found that the requirement for satisfying a "minimal connection" for nexus is the same for both Due Process and Interstate Commerce. *Trinova Corp. v. Michigan Department of Treasury,* 111 S.Ct. 818 (1991); *Amerada Hess Corp. v. Director, Division of Taxation,* 109 S.Ct. 1617 (1989). The broad test applied to determine whether nexus exists in a state is simply one of asking whether the state has provided some protection, opportunity, or benefit for which it can ask a return. *Wisconsin v. J. C. Penney Co.,* 61 S.Ct. 246 (1940). The exploitation of a state's market or the presence of the taxpayer's intangible property in the state are [sic] each by themselves sufficient to satisfy the nexus requirement of Due Process. In the instant matter, both exploitation of South Carolina's market and the presence within South Carolina of intangible property are demonstrated.

i. Exploitation Of South Carolina's Market By The Taxpayer.

The application of the nexus test does not turn on the physical presence in the state of the taxpayer. Rather, the critical element is the taxpayer's effort to exploit the economic market provided by the State. This view has been succinctly stated by the United States Supreme Court in *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*, 107 S.Ct. 2810, 2821 (1987):

> . . . the crucial factor governing nexus is whether the activities performed in this state on behalf of the taxpayer are significantly associated with the taxpayer's ability to establish and maintain a market in this state for the sales.

The exploitation of a state's market has been held to be a sufficient basis upon which to find a valid nexus within the meaning of Due Process. In *American Refrigerator Transit Co. v. State Tax Commission*, 395 P.2d 127 (1964), the taxpayer, a lessor of railroad cars, was held liable for income tax in a state in which it did no business except that its lessees used the leased property in the state. In upholding the tax, the Oregon Supreme Court stated the following:

> The connection between the taxing state and the out-of-state taxpayer necessary to establish nexus is essentially an economic rather than a physical relationship . . .
>
> The nexus exists whenever the corporation takes advantage of the economic milieu within the state to realize a profit. The state is entitled to tax if the benefits it provides are a substantial economic factor in the production of the taxpayer's income. These benefits are found in the maintenance of conditions essential to the production or marketing of goods. They may be realized simply in the protection of the taxpayer's property used in the production of income.

> . . . Nexus may be found even where neither property nor personnel of the taxpayer is employed within the taxing state if it can be said that the state substantially contributes to the production of the taxpayer's income.

Under the facts of the instant case, the taxpayer has sought to exploit South Carolina's market for its gain. Here the trademark was continually and systematically used to exploit South Carolina's retail markets through its display in the six retail locations in the state. The trademark is used in all print and media advertising campaigns. To ensure the market remained favorable to the trademark's ability to generate royalties, the taxpayer may defend the trademark against infringement in South Carolina. Further, Article VI at 6.3 allows the taxpayer further control of the activity by giving the taxpayer the right of approval over the advertising and products sold by Toys "R" Us.

ii. The Taxpayer's Intangibles Are Present In The State.

The presence of property in a state from which the taxpayer derives its income and over which the state provides protection is a significant contact which satisfies the minimal contact required by Due Process. *Northwestern States Portland Cement Co. v. Minnesota* and *Williams v. Stockham Valves & Fittings, Inc.*, 79 S.Ct. 357 (1959). In the instant case, the taxpayer has property in South Carolina from which it derives income and over which South Carolina provides protection. Therefore no violation of the nexus principle is found here.

The property located in South Carolina consists of intangible property in two distinct forms: first, a franchise and second, debts owed to the taxpayer arising from the franchise. The nature and location of these intangibles are discussed below.

The taxpayer's activities have created a franchise and a debt receivable. A franchise is defined as the license

from the owner of a trademark or trade name permitting another to sell a product under that trade name or permitting another to sell a product or service under the mark. *Black's Law Dictionary*, 592 (5th ed. 1979). Here the taxpayer is the owner of several trademarks and the taxpayer, by a written agreement, has permitted Toys "R" Us to utilize that trademark. Thus, the agreement between the taxpayer and Toys "R" Us has created a franchise. Further, additional property was created by the taxpayer through the owning of accounts receivable generated by the franchise. Article V at section 5.1 states that the royalties are to be paid annually in February, but under 5.2, the payments accrue on a monthly basis. Thus, until the annual payment in February, there is a growing accounts receivable generated by the franchise.

Having identified the income-producing property created by the taxpayer's activity, it is necessary to find the location of that property. If the location is in South Carolina, such presence is sufficient minimal contact to satisfy Due Process.

It is established that an intangible has a location of the domicile of the owner of the property until that property has been integrated with an activity carried on in another state. At that point, the taxable situs is in the state where the activity is conducted. *Wheeling Steel Corp. v. Fox*, 298 U.S. 193 (1936). This point is well stated in *Tuition Plan of New Hampshire v. Director, Division of Taxation*, 4 N.J. Tax 470 (1982).

> . . . the situs of an intangible and the place where income is earned are one and the same issue.

In the instant case it is clear that the income is earned in South Carolina. The purpose of the license agreement is to encourage sales in South Carolina. In fact, whenever a sale is made it is because of the franchise agreement which allows the seller to use the well known and respected Toys "R" Us symbol. The license is in South Carolina since it is integrated with the business carried on here. The same is true with the debts receivable by

the taxpayer from Toys "R" Us. Those debts are created solely as a result of the license agreement. The debt is just as integral to the activities in South Carolina as is the license agreement. In short, the intangibles are integrated with the royalty producing activity in South Carolina.

b. The Apportionment Formula.

Compliance of an apportionment formula with Due Process and Interstate Commerce is found by applying the following test set out by the United States Supreme Court in *Container Corporation of America v. Franchise Tax Board,* supra.

> . . . an apportionment formula must, under both the Due Process and Commerce Clauses, be fair. See Exxon Corp., supra, 447 U.S. at 219, 227-228, 100 S.Ct., at 2118, 2122-2123; Moorman Mfg. Co., 437 U.S. at 272-273, 98 S.Ct. at 2343-2344; Hans Rees' Sons, Inc., 283 U.S. at 134, 51 S.Ct. at 389. The first, and again obvious, component of fairness in an apportionment formula is what might be called internal consistency—that is, the formula must be such that, if applied by every jurisdiction, it would result in no more than all of the unitary business income being taxed. The second and more difficult requirement is what might be called external consistency—the factor or factors used in the apportionment formula must actually reflect a reasonable sense of how income is generated. The Constitution does not 'invalidat[e] an apportionment formula whenever it may result in taxation of some income that did not have its source in the taxing State . . .' Moorman Mfg. Co., supra, 437 U.S. at 272, 98 S.Ct. at 2344 (emphasis added). See Underwood Typewriter Co., 254 U.S. at 120-121, 41 S.Ct. at 46-47. Nevertheless, we will strike down the application of an apportionment formula if the taxpayer can prove 'by "clear and cogent evidence" that the income attributed to the State is in fact "out of all

> appropriate proportions to the business transacted . . . in that State," [Hans Rees' Sons, Inc.] 283 U.S. at 135, 51 S.Ct. at 389, or has "led to a grossly distorted result," [Norfolk & Western R. Co. v. State Tax Comm'n., 390 U.S. 317, 326, 88 S.Ct. 995, 1001, 19 L.Ed.2d 1201 (1968)].' Moorman Mfg. Co., supra, 437 U.S. at 274, 98 S.Ct. at 2345.

These tests must be applied to South Carolina's apportionment statutes.

i. Internal Consistency.

The internal consistency test is simply one part of a two-part test of seeking fairness. The "internal" part of the test seeks only to determine if the formula itself is capable of dividing the "income pie" into slices that account for 100% of the income. The internal consistency test is one of asking "can the formula work" rather than asking "does the formula work." (The latter is essentially the "external consistency" part of the test.) Such being true, it is not relevant to the internal consistency test what another taxing jurisdiction may or may not be doing in taxing Geoffrey's royalty income.

The proper application of the test is to apply the test as though every jurisdiction, foreign and domestic, used South Carolina's apportionment formula. If all jurisdictions used the identical gross receipts formula South Carolina uses, only 100% of the taxpayer's income is taxed. This is true since each jurisdiction would receive a portion of the income based only on the percentage of the gross receipts from within their state as required by § 12-7-1190. Accordingly, no more than 100% of the income could ever be taxed.

ii. External Consistency.

The test of fairness under the Due Process and Commerce Clauses also requires satisfying an external consistency test which seeks to show that the apportionment

factors "reflect a reasonable sense of how income is generated." *Container Corp.*, 463 U.S. at p. 169. In this formulation of the test, the court underscores the view that the in-state factors in the formula are only to be reasonable. Exactness is not a requirement. In fact, to develop the view that rough approximations are valid, the *Container* court identified the outer limits of what is reasonable by expressing the following at 103 S.Ct. at p. 2942:

> . . . we will strike down the application of an apportionment formula if the taxpayer can prove 'by "clear and cogent evidence" that the income attributed to the State is, in fact, "out of all appropriate proportions to the business transacted . . . in that State," [Hans Rees' Sons, Inc.] 283 U.S. at 135, 51 S.Ct. at 389, or has "led to a grossly distorted result," [Norfolk & Western R. Co. v. State Tax Comm'n., 390 U.S. 317, 326, 88 S.Ct. 995, 1001, 19 L.Ed.2d 1201 (1968)].' Moorman Mfg. Co., supra, 437 U.S. at 274, 98 S.Ct. at 2345.

In the instant case the gross receipts formula does "reflect a reasonable sense of how income is generated." The sole source of income in South Carolina by the taxpayer is that derived from royalties. The amount of those royalties is the very measure that South Carolina uses to determine the percentage of the taxpayer's net income. In other words, the taxpayer does not pay tax on its total income. Rather, it pays tax based on the percentage of its total royalties that are produced in South Carolina. Thus, if there are no royalties produced in South Carolina there are no taxes due and if only 10% of the taxpayer's royalties are in South Carolina, the taxpayer pays tax on 10% of its net income. Such a formula is inherently "reasonable".

3. Allocation Under § 12-7-1120 or § 12-7-1130.

The allocation provisions of § 12-7-1120 require that income from certain classes of property must be allocated

to a particular location. The taxpayer argues that its royalty income must be allocated to Delaware under some provision of § 12-7-1120. This position is incorrect.

There is only one reference in 12-7-1120 to allocating royalty income and that section in pertinent part is as follows:

> . . . royalties received from tangible property, . . . less all related expenses, shall be allocated to the state in which the property was located at the time the income was derived.

This section pertains to royalty income from "tangible property." Here the property producing the royalty income is a license and such property is unquestionably intangible property. Thus, § 12-7-1120 does not allocate the royalty income at all.

Further, even if this section were to apply the royalty income here would be allocated in full to South Carolina rather than to Delaware. Such is true since the income is taxed where the property that produced it was located. As developed previously in this Order, the license that generated the royalty here in dispute is located in South Carolina since the license is an integrated part of the taxpayer's activities here.

Finally, § 12-7-1130 does not allocate the royalty income here in dispute. That section allocates income only when the income in question is from "any other investments" not covered in § 12-7-1120. In other words, the activity under review must be an investment activity and the income from that investment activity must not be of the type already allocated by § 12-7-1120.

Here the royalty income is not that generated by an investment activity. Rather, it is clear that the taxpayer is carrying on a business of producing royalty income by the active management and exploitation of numerous markets. Because of such, none of the royalty income is allo-

cated to Delaware. Rather, the taxpayer's net income is taxed on an apportionment basis under § 12-7-1190.

Finally, § 12-7-1130 allocates the income to the situs of the investment. Here the situs of the investment is the place where the income is earned, i.e. South Carolina. Thus, even application of § 12-7-1130 does not help the taxpayer.

4. License Tax.

The license tax is determined under the same method as the tax on income. Thus, this court holds the license tax is also proper for the same reasons the income tax is proper.

C. Conclusion

Based on the facts, the longstanding administrative interpretation, and the case law, Geoffrey is carrying out activities in South Carolina for the purpose of profit and financial gain so as to be taxable under § 12-7-230. The activities in and contacts to South Carolina are of such a magnitude that South Carolina's taxing of a small portion of the taxpayer's net income does not violate Due Process or Interstate Commerce. Further, §§ 12-7-1120 and 12-7-1130 are inapplicable to the taxpayer. There is no basis for allocating the income of the taxpayer to Delaware. Accordingly, the court upholds the Tax Commission's assessment and dismisses the taxpayer's Complaint.

AND IT IS SO ORDERED.

/s/ Larry R. Patterson
LARRY R. PATTERSON
Judge
Thirteenth Judicial Circuit

Greenville, South Carolina
February 27, 1992.

APPENDIX C

STATE OF SOUTH CAROLINA
BEFORE THE
SOUTH CAROLINA TAX COMMISSION

In Re:

A Finding Concerning The Income Tax Liability Of Toys "R" Us For Tax Years 1986 And 1987 And For Geoffrey, Inc., For Tax Years 1986 And 1987.

FINDINGS OF FACT

Toys "R" Us, Inc. (Toys), incorporated under the laws of Delaware in 1928, is a multistate corporation engaged in the retail sale of toys and children's apparel throughout South Carolina, the United States and in several foreign countries. Toys began doing business in South Carolina in 1985.

In 1984, Toys created a wholly owned subsidiary, Geoffrey, Inc. (Geoffrey). The registered trademarks (Geoffrey the Giraffe, Toys "R" Us, Kids "R" Us and "R" Us) of Toys were then transferred to the subsidiary in a tax free transaction under Internal Revenue Code Section 351. A license agreement was then executed in which Toys agreed to pay Geoffrey a royalty of 1% of net sales for the right to use these trademarks in Toys' business operations. These royalty payments have been deducted from apportionable income by Toys. The license agreement requires that Geoffrey register and renew all trademark registrations and protect the trademarks from trademark infringers. Geoffrey is a Delaware holding company and has not filed or paid income tax to South Carolina.

CONCLUSIONS OF LAW

We find and conclude the royalty payments to Geoffrey by Toys are deductible by Toys as part of the computation to arrive at Toy's [sic] apportionable income. We, however, find that Geoffrey has sufficient nexus in South Carolina to require the filing of a return and the payment of South Carolina income tax on its income.

Geoffrey is "doing business" in South Carolina and is subject to income tax here. Section 12-7-230 provides the Commission with broad authority to impose an income tax on foreign corporations engaged in interstate commerce:

> "Every foreign corporation transacting, conducting, doing business or having an income within the jurisdiction of this State, whether or not such corporation be engaged in or the income derived from intrastate, interstate, or foreign commerce, shall make a return and shall pay annually an income tax equivalent to six percent of a proportion of its entire net income, to be determined as provided in this chapter. *The term 'transacting,' 'conducting' or 'doing business' as used in this section shall include the engaging in or transacting of any activity in this state for the purpose of financial profit or gain.*" (Emphasis added)

Geoffrey is engaged in business in this State for the purpose of financial profit or gain. The Toys "R" Us trademark is continually and systematically used to exploit South Carolina's retail markets. The trademark is displayed in and on all six South Carolina retail locations. The mark is used in all print and media advertising campaigns. Geoffrey is contractually obligated to investigate and defend the trademarks against infringement in this State. Geoffrey received royalties of $177,000 from Toys' South Carolina activities during the audit period for use of the mark.

We find that the license agreement between Toys and Geoffrey is present in this State since that agreement is

the means by which Geoffrey derives its income here. See *In re Heftal Broadcasting Honolulu, Inc.*, 554 P.2d 242 (1976). Further, when an intangible is integrated with a business in the State, the situs of the intangible and the place where the income is earned are one and the same. *Tuition Plan of N.H. v. Director, Div. of Taxation*, 4 N.J. Tax 470 (1982).

We note that *Western Acceptance Co. v. State Dept. of Revenue*, 472 So.2d 497 (1985), also supports our view. There, Western Auto transferred their customer receivables to a wholly owned subsidiary, Western Acceptance. Acceptance owned no property other than cash and receivables and had no employees or offices in or out of Florida. All business functions of the subsidiary were carried out by employees of the parent.

The Court ruled that Western Acceptance had sufficient contacts with the state to be "doing business" subject to taxation. Acceptance's activities in substance were conducted by and were the direct result of Western Auto's activities. Acceptance was found to be doing business in Florida because, "but for" Western Auto's activities on Acceptance's behalf, Acceptance could not have conducted any business or earned any income.

An analysis of the pro forma tax returns of Geoffrey reveals that Geoffrey likewise has no full time employees and does not own any property. The legal services for trademark infringement are provided by outside counsel. Here, as in the Western Acceptance decision, the income of the subsidiary is a direct result of the efforts of the parent. Geoffrey is likewise subject to state income taxation.

The final issue concerns Toys' method for computing expenses related to dividend income. Toys received $30,000,000 in dividend income in each of the years under examination. All of this income is allocated outside of South Carolina. For the year ending February,

1983, $11,000,000 of these dividends were paid by Geoffrey.

Related expenses were calculated as follows using the "DC Formula":

	FYE 2/1/86	FYE 2/1/87
Investment Assets	$ 323,797,161	$ 184,777,606
Total Assets	$1,004,834,521	$1,169,214,230
Ratio	32.2239%	15.8036%
Interest Expense	$ 22,593,962	$ 23,934,681
Related Expense	$ 7,280,656	$ 3,782,541

Section 12-7-1120(2) allocates the dividends "less related expenses." We are unable to find where the taxpayer has demonstrated that the interest expense is related to specific items. Thus, we are required to arrive at a reasonable method of sharing the interest expense between investment assets and the taxpayer's other assets. We find the "DC formula" to be appropriate and thus uphold the Division's position.

Finally, a penalty was imposed due to Geoffrey's delinquency. Since we have the authority to waive penalties and since this is the first opportunity Geoffrey has had to fully understand our law on taxability of income earned through the use of trademarks, we waive the penalty involved.

AND IT IS SO FOUND AND ORDERED.

SOUTH CAROLINA TAX COMMISSION

/s/ S. Hunter Howard, Jr.
S. HUNTER HOWARD, JR.
Chairman

/s/ A. Crawford Clarkson, Jr.
A. CRAWFORD CLARKSON, JR.
Commissioner

Columbia, South Carolina
July 20, 1990

APPENDIX D

[SEAL] MULTISTATE TAX COMMISSION
National Nexus Program

August 20, 1993

Toys R Us
Mr. John Salvia
Tax Manager
395 West Passaic Street
Rochelle Park, NY 07662

Dear Mr. Salvia:

The Multistate Tax Commission National Nexus Program is an organization formed by a group of states in an effort to increase state tax compliance. One of the activities of the Nexus Program is to help its member states identify multistate companies that may have compliance problems. The Nexus Program also provides registration information as a mechanism for these companies to voluntarily resolve potential income/franchise tax liabilities in several states at one time.

We understand that your company and Geoffrey, Inc. may be transacting, conducting, doing business, or deriving income within the jurisdiction of various states. Many states impose income tax nexus based on minimal activities (including the licensing of intangible property rights) performed within the State. As a result of these activities, some states may require your company and/or its subsidiaries to register and remit state income/franchise taxes.

To help us determine whether further inquiry is appropriate, we request that you complete the enclosed Nexus Questionnaire and return it to me in the enclosed envelope by September 20, 1993. If you fail to respond by the above due date, or if your responses are inadequate, we may request that member states authorize a through [sic] investigation.

I have also enclosed information about our Nexus Program, including information that describes in some detail our voluntary settlement process. If you would like to discuss whether your company might be eligible for a voluntary settlement with our Program states or if you have any other questions, please contact me directly at 202-508-3807.

Sincerely,

/s/ Alice J. Davis
ALICE J. DAVIS
Director

Enclosures

mg/wp51/toysrus.cov

APPENDIX E

STATUTORY PROVISIONS

Sec. 12-7-230. Tax on corporations.—(A) Every corporation organized under the laws of this State, whose entire business is transacted or conducted within this State, shall make a return and shall pay annually an income tax equivalent to five percent of the entire net income received by such corporation during the income tax year, and except as otherwise provided, every corporation organized under the laws of this State, doing or transacting business partly within and partly without this State, shall make a return and shall pay annually an income tax equivalent to five percent of a proportion of its entire net income to be determined as provided in this chapter, and except as otherwise provided, every foreign corporation transacting, conducting, doing business or having an income within the jurisdiction of this State, whether or not the corporation is engaged in or the income derived from intrastate, interstate, or foreign commerce, shall make a return and shall pay annually an income tax equivalent to five percent of a proportion of its entire net income, to be determined as provided in this chapter. The term "*transacting*," "*conducting*," or "*doing business*," as used in this section shall include the engaging in or the transacting of any activity in this State for the purpose of financial profit or gain.

(B) In the case of any corporate taxable year beginning before January 1, 1989, the rate imposed by subsection (A) does not apply and the following rates apply:

(1) six percent for corporate taxable years beginning before 1988,

(2) five and one-half percent for corporate taxable years beginning in 1988.

Sec. 12-7-1190. Computations in regards to remaining income of other taxpayers.—If the principal profits or income of a taxpayer, other than those described in former 1962 Code § 65-256 or § 12-19-100, are derived from sources other than manufacturing, producing, collecting, buying, assembling, processing or selling, distributing or dealing in tangible personal property such taxpayer shall make returns and pay annually an income tax upon a proportion of its remaining net income computed on the basis of the ratio of gross receipts from within this State during the income year to the total gross receipts of such year within and without the State.

Sec. 12-19-70. Imposition of license tax on corporations generally; rate; minimum tax; time payable.—In addition to all other license taxes or fees or taxes of whatever kind, every corporation required to file the report by Section 12-19-20 except the corporations enumerated in Section 12-19-100, shall pay to the Commission at the time of filing the report as required by Section 12-19-20 an annual license fee of fifteen dollars plus one mill on each dollar paid to the capital stock and paid in as surplus of the corporation as shown by the records of the corporation on the first day of the income year next preceding the date of filing the report. In no case may the license fee provided by this section be less than twenty-five dollars. The license fee provided for by this section must be paid at the time of filing the report pursuant to the provisions of Section 12-19-20. The phrase "*paid in as surplus*" for the purposes of Chapter 19, Title 12, means the entire surplus of a corporation other than its earned surplus as defined below, and includes any charges against earned surplus reflected in the balance sheet except charges for reserves.

For purposes of this section, "*earned surplus*" means that portion of the surplus of a corporation equal in amount to the balance of its net profits, income, gains, and losses from the date of incorporation, or from the

latest date when a deficit was eliminated by application of its capital surplus, after deducting subsequent distributions to shareholders and transfer to stated capital and capital surplus to the extent that such distribution and transfers are made out of earned surplus. Unrealized appreciation of assets shall not be included in earned surplus.